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Bankers Acceptances as an Investment

By
MORTON H. FRY

AMERICAN ACCEPTANCE COUNCIL
120 Broadway New York

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Foreword

THOSE who founded the Federal Reserve System and those who since its inception have been directing its destinies have recognized that the bank acceptance is the keystone to the Federal Reserve System. In order that the bank acceptance may reach its full fruition, it is necessary that a market be created and maintained in which these instruments of trade can be rediscounted readily at attractive and reasonably stable rates. A large number of buyers and sellers is essential to a broad market in any security or commodity.

In our acceptance market, thanks to the efforts of the Federal Reserve Board, the Federal Reserve Banks and bankers generally, most of our leading financial institutions and private bankers are now using the acceptance as one of the means of financing the commercial transactions of their clients. There are, therefore, a great many sellers of bills. It is with the hope of increasing the number of buyers of these prime instruments of credit, by presenting in an elementary manner the advantages of bank acceptances as an investment, that this pamphlet is issued.

Bank acceptances continue to demonstrate through a great variety of conditions in the money markets that they are one of the most desirable types of short term investments. In view of the gradual reestablishment of the gold standard throughout the world, their increased use and the consequent broadening of the open market in this country becomes of even greater importance than heretofore in connection with the safeguarding of our gold supply in the

future and with the renewal of the free international flow of credits. The decrease in the amount of short term Government indebtedness outstanding will, undoubtedly, in the next few years, tend to broaden very considerably the field of the acceptance as an investment by making available large sums that have hitherto been carried by banking institutions, corporations and individuals in short date Government securities. We may look forward with confidence to a steady and sustained growth. It is to be hoped, therefore, that those who have labored so indefatigably for the establishment of an open discount market in this country worthy of the name will continue and increase their efforts to that end.

This pamphlet is particularly directed to those investors — whether corporations or individuals — that have not yet been buyers of acceptances or that have bought only sporadically and to whom the inherent advantages possessed by bank acceptances should appeal.

—M. H. F.

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Bankers Acceptances As a Short Term Investment

Bankers acceptances have continued to demonstrate through a great variety of conditions in the money markets that they are one of the most desirable types of short term investment. In view of the gradual reestablishment of the gold standard throughout the world their increased use and the consequent broadening of the open market in this country becomes of even greater importance than heretofore in connection with the safeguarding of our gold supply in the future and with the renewal of the free international flow of credits. The decrease in the amount of short term Government indebtedness outstanding will undoubtedly in the next few years tend to broaden very considerably the field of the acceptance as an investment by making available large sums that have hitherto been carried by banking institutions, corporations and individuals in short date Government securities. We may look forward with confidence to a steady and sustained growth. It is to be hoped, therefore, that those who have labored so indefatigably for the establishment of an open discount market in this country worthy of the name will continue and increase their efforts to that end.

In considering the advisability of any short term investment there are three general tests that should be applied:

1. Is it safe? Is there reasonable assurance of the return of principal at maturity with interest for the period the funds have been invested?
2. Is it liquid? In the event of funds being required prior to maturity can the security be turned into cash readily and without substantial loss?
3. Can the securities be obtained in desired denominations and maturities?

It is on the basis of these three general considerations that the investor should select his short term investments.

Judged by these requirements bank acceptances of the types eligible for purchase and rediscount by the Federal Reserve Banks may properly be regarded as one of the most desirable forms—if not the most desirable form—of short term investment. They combine to an unusual extent these important requisites—safety, liquidity and convenient maturity and denomination.

Safety

1. The bank acceptance is the direct and incontestable obligation of the accepting bank or banker. It is the definite promise of the accepting institution to pay on a definite date the sum stated on the face of the bill. It is, therefore, in effect, the cashier's check of the accepting bank or banker payable at a fixed future date. In the eyes of the law it ranks in security with a deposit with such bank or banker.

2. It has an additional factor of safety in that the drawer and any endorsers are liable for the payment of the face amount of the bill in the event that the accepting institution fails to make payment at maturity. It will, therefore, be apparent that the holder of a bank acceptance has at least the same degree of security as if his funds were deposited with the accepting bank or banker, plus such security as is afforded by the name of the drawer and endorser.

3. Under the law, bank acceptances are one of the very few types of securities which the Federal Reserve Banks are allowed to purchase in the open market. Special legislation has also been enacted in many states giving express permission to savings banks and trustees in those states to invest a portion of their funds in bank acceptances under certain rules and regulations. This is both an evidence of their safety and a factor of their liquidity. It may also be worth while to point out that the National Bank Act was amended in November, 1919, so as to exempt eligible bank acceptances from application of the 10% limitation, that is to say, the law as it now stands expressly states that no limitation is to be placed upon the amount of acceptances of any one bank that may be held by a national bank or banking institution.

Liquidity

1. Bank acceptances when properly drawn are based upon actual commercial transactions and are self-liquidating in their nature. In times of stress, therefore, bank acceptances, because of their nature, should be liquidated according to their tenor, by the liquidation of the underlying transaction, even when other forms of credit obligations become "frozen." Actual experience through such a month as December, 1920, is evidence of the soundness of this feature.

2. Under the terms of the Federal Reserve Act and according to the regulations of the Federal Reserve Board, acceptances of the types here discussed are eligible for purchase and rediscount by the Federal Reserve Banks. When acquired by any Federal

Reserve Bank they may be used as a basis for the issue of Federal Reserve currency and therefore become a part of the security underlying the most important part of our currency. Thus the bank acceptances themselves furnish a medium by which funds may be created for their purchase, even in times of stringency when cash for the purchase of some other securities would not be available.

3. Eligible bank acceptances have a broad open market in which millions of dollars of bills change hands each day at rates varying generally not more than ⅛% to ¼% per annum between the bid and offered prices. The fact that the Federal Reserve Banks under the law are permitted to purchase them tends to stabilize rates on this class of obligation and to insure a market for them even in times of extreme stress.

4. The holder of an eligible bank acceptance, therefore, may feel, first, that because of the nature of the obligation it will be met promptly at maturity and, second, that if at any time during the life of the acceptance he desires to obtain his funds he will be able to do so either by selling it in the open market or by discounting the obligation through his bank.

Convenient Maturities and Denominations

Bank acceptances are to be had in the open market in maturities running anywhere from a few days to as long as six months. The general run of bills offered varies in maturity from about thirty days to ninety days. An investor anticipating a demand for

his funds is usually able to buy bills maturing on or about the date at which he expects to need his funds. Of course, even if this were not the case he would still be able, because of the market which has been developed, to obtain funds by selling his holdings in the open market.

Bank acceptances are drawn in varying denominations. Based as they are on actual commercial transactions, the denominations usually will vary with the size of the underlying transaction. In some cases where the amount involved is a large one it has been the custom to make up the entire amount so far as possible in denominations of $5,000 or multiples thereof. However, there are a great many bills appearing in the open market in denominations of anywhere from a few hundred dollars to five thousand dollars so that the prospective buyer will generally be able to invest approximately such an amount as he may desire.

Investors in Acceptances

Because of the characteristics of prime eligible bank acceptances, which have been pointed out, these instruments of finance have become recognized by the most important financial institutions in the country as an exceedingly desirable form of short term investment. Among the buyers in large quantities at this time are the national banks, state banks and trust companies. Laws have been passed in a great many states, notably in New York and Massachu-

setts, permitting savings banks and trustees to invest a certain portion of their funds in certain classes of eligible bills. Corporations accumulating funds for dividends, interest requirements and other purposes are turning to bank acceptances as a means for the employment of such funds pending their distribution. Insurance companies also in a great many cases are keeping a portion of their current funds in prime bank acceptances and even private investors and business men having idle funds on hand have during recent months in increasing numbers been utilizing bank acceptances. It is, therefore, apparent that the bank acceptance makes its appeal to all classes of investors, whether individuals or corporations, having idle funds temporarily on hand.

How to Buy Bills

There is, as has been pointed out, a broad open market for bank acceptances. This market is made up of a number of firms and corporations which specialize in handling bank acceptances and whose turnover amounts to many millions per day. These acceptance dealers have at all times a supply of bills on hand of different names, amounts and maturities, from which the prospective purchaser can choose. Their operations are confined not only to New York City, which has become the primary bill market of the country, but includes practically all the larger cities in the country. The American Acceptance Council will be glad, upon application, to furnish a list of the names of acceptance dealers. In the event that the prospective purchaser for any reason does not wish to approach the dealers, it is possible

for him to communicate with his bank and entrust to it his purchases of acceptances. All prices quoted are on a discount basis, that is, the purchaser pays the face amount of the acceptances, less discount at a given rate to maturity.

How to Sell Bills

Merely for the purpose of illustration, the following elementary example is given of the method of figuring a transaction in bankers acceptances:

Acceptance of..National Bank

for \$25,192.74

due Jan. 18, 1929, at 3⅛%.

Figure actual days to maturity—79 days.

Multiply the face amount \$25,192.74 by number of days to maturity, 79 days, and divide the answer by 100, the result being 19,902, which is called the "numbers." The "numbers" represent discount at 360% on the given face amount for the given number of days of discount. By pointing off one place (or dividing by ten) the result would be the discount at 36% and this amount divided by 12 gives the discount at 3%, which amounts to \$165.85. The latter figure divided by 3 is 1% or \$55.28; this in turn divided by 8 results in ⅛ of 1% or \$6.91. Adding the amount of 3% (\$165.85) to that of ⅛% (\$6.91) gives the required discount of 3⅛%, which amounts to \$172.76.

Subtract the discount, \$172.76, from the face amount \$25,192.74 and the result will be the net proceeds, \$25,019.98.

As follows:

$25,192.74 due Jan. 18, 1929, at 3⅛%.

$25,192.74 face amount

X 79 days to maturity

19,902.2646 "numbers" or 360% discount

12) 1,990.2 — 36% discount

3) 165.85 — 3% discount

8) 55.28 — 1% discount

6.91 — ⅛% discount

$165.85 3% discount

plus 6.91 ⅛% discount

$172.76 3⅛% discount

$25,192.74 face amount

minus 172.76 discount at 3⅛%

$25,019.98 net proceeds.

If at any time prior to the maturity of a bill the holder desires to sell it and obtain his funds he may again get into communication with one of the acceptance dealers who will make a net bid for his holdings, paying therefor by check upon receipt of the bills, or by depositing the funds to the seller's credit with whatever bank may be specified. Here again, however, the holder may utilize his own bank for the sale of his acceptances, such bank in turn either selling to one of the acceptance dealers or to its Federal Reserve Bank—or holding the bills for its own investment. The holder of prime acceptances may, therefore, regard them practically in the same light as his bank balance in that he can obtain the use of his funds on a few hours' notice.

Money at Call Against Bankers Acceptances as Collateral

The necessity devolving upon acceptance dealers of carrying good-sized portfolios for the purpose of meeting the requirements of bill buyers lays upon them the further necessity of finding a supply of call money to carry such portfolios pending their distribution. There has accordingly in recent years grown up, particularly in New York City, a special call money market against bank acceptances as collateral, the rate being somewhat below the call money rate on loans secured by other forms of collateral. This rate, moreover, is relatively stable as the requirements for this type of call loan do not fluctuate to any great extent with the volume of transactions in security markets. Banks and banking institutions therefore who may not be purchasers of bills but who may, nevertheless, have sizable sums of money available only for a very short time for use in the bill market can utilize this phase of the open discount market for the employment of such funds. Particularly from the point of view of the institution with large amounts of surplus funds on hand for very limited periods of time call money against bankers acceptances affords a convenient and logical method of utilizing such funds. Such loans as a rule are made in large amounts and therefore relieve the lending institution of clerical labor and detail in their inception. The collateral securing them fluctuates so little in market value as to require no attention as contrasted with certain other types of collateral loans and there is the further assurance to the lender—remote though such a contingency may now appear—that his loan even under

conditions of the utmost stress will not become frozen and from a call loan develop into an indeterminate time loan. Moreover, the well considered use of the call loan market on bankers acceptances by our larger and even by our smaller banking institutions could be made to bring about a greater stability in the call money market as a whole. There have been occasions even during the past year when call money against stocks and bonds as collateral was practically unlendable and when call money rates as a result were unduly depressed. Such a condition benefits no one, least of all the would-be lending banks. During such times the utilization of a portion of such surplus funds in the purchase of bills or in call loans on bills even at rates that might seem to be slightly below call rates on stocks and bonds would relieve the pressure and prevent an undue decline in rates. Obviously an institution that has say $20,000,000 to loan on call is in better position if having lent say $15,000,000 at 3% and finding the balance hard to lend withdraws it and places it in the bill market even at 2½% than if by trying to lend such surplus it forces the rate on the entire amount to 2½%. Of course, one institution working singly would be ineffective in stabilizing rates but with intelligent cooperation the banking community as a whole could undoubtedly prevent most of the sharp fluctuations in the call money market on stocks and bonds through operations in the bill market whether through the purchase of bills or through loaning against them. This is a phase of the situation that will demand increasing attention as the extraordinary influences of short term Government financing disappear. Apart from Government securities the only investments Federal Reserve Banks may make are

those in acceptances and other bills of exchange (except for certain short term municipal tax anticipation notes which we may disregard). Therefore in normal times the Federal Reserve Banks can exercise an influence on the money market only through the bill market and conversely the only way through which the money market can avail itself of the resources of the Federal Reserve System directly will be through the operations in the bill market.

Method of Collecting Acceptances at Maturity

Holders of acceptances about to mature (providing such holders are not in the banking business themselves) should deposit the bills with their bank or banker for collection. Particular care should be taken to make such deposit in ample time to allow the bills to be forwarded to their place of payment for presentation on the date of maturity. This should be done for two reasons: First, in order to be reimbursed promptly for the principal amount of the bills; and second, because it has been held by competent counsel that failure to present bills at the place of payment on the date of maturity might tend to release the drawer and endorsers from liability.

The bank or banker receiving such bills for collection will proceed to put them through in the regular way and credit his customer with the proceeds as soon as payment is received. The Federal Reserve Banks have offered special facilities for the collection of bank and bankers acceptances, so that a member bank which receives such bills from customers for collection and places them with its Federal Reserve Bank in due time, will be able

to take credit for them on the day of maturity when the place of payment designated is in any city where a Federal Reserve Bank or a branch of a Federal Reserve Bank is located. As of January 1, 1925, Federal Reserve Banks or branches of such banks were located in the following cities: Boston, New York, Buffalo, Philadelphia, Cleveland, Cincinnati, Pittsburgh, Richmond, Baltimore, Charlotte, Atlanta, New Orleans, Jacksonville, Birmingham, Nashville, Chicago, Detroit, St. Louis, Louisville, Memphis, Little Rock, Minneapolis, Helena, Kansas City, Oklahoma City, Omaha, Denver, Dallas, El Paso, Houston, San Antonio, San Francisco, Spokane, Portland, Seattle, Salt Lake City and Los Angeles.

Acceptances payable in cities other than one in which a Federal Reserve Bank or a Federal Reserve branch is located are taken on a basis of a slightly deferred credit but the outstanding amount of such acceptances is so small that for practical purposes it may be disregarded.

The bank acceptance is a comparatively new instrument of credit in this country but it has stood the test of our war and post-war periods and is today more firmly established than ever. For years it has been one of the most important features of the older financial markets of the world and has contributed in large degree to their supremacy. The possessor of idle funds who buys bank acceptances is therefore not only utilizing his funds in a safe, profitable and convenient way, as has been shown, but is assisting directly in fostering our domestic and foreign commerce, in emancipating it from foreign credits, and in establishing our financial system upon a better and stronger basis.

Extract from Report of Frank L. Palmer

Former Bank Commissioner of the State of Maine

During the past several years we have come to realize more fully the importance of maintaining our banking institutions in a more liquid condition. As the average rate of return on savings bank investments is comparatively low, it is desirable that the bank's balance of idle funds should be as small as is consistent with its needs. At the same time it is important that the bank should maintain an adequate secondary reserve to meet unusual withdrawals in excess of current deposits. High grade securities are no longer looked upon as a desirable secondary reserve as the bank is liable to have occasion to resort to such reserve at a time when securities can be disposed of only at a great sacrifice.

The savings bank's secondary reserve should consist of a suitable amount of assets which yield a fair rate of return, and at the same time are immediately convertible into cash without sacrifice even under abnormal conditions. Bank acceptances, eligible for rediscount with Federal Reserve banks, are readily convertible into cash without material loss even under depressed market conditions and therefore make an ideal secondary reserve. As the acceptances approach maturity they become even more attractive as a liquid investment and the savings banks, having occasion to dispose of them before maturity, can often do so at a better rate than that at which they were purchased. With such a reserve in times of stress, the savings institutions would no longer have occasion to liquidate their long term securities or depend upon their correspondent banks for assistance. In this connection I desire to

call the attention of savings banks Trustees to the provisions of Chapter 50 of the Laws of 1919. This Act of the last Legislature permits savings banks to invest in acceptances which are eligible for rediscount with the Federal Reserve banks, provided they have been accepted or endorsed by a Trust Company incorporated under the laws of this State, or a member of the Federal Reserve System located in New England or the State of New York.

The investment of savings deposits in such acceptances would in no respect lower the conservative standard established for savings bank investments. In fact, bank acceptances would be even safer than the deposit of funds in the accepting bank, as the acceptance is not only the obligation of the bank accepting the bill, but also has the added strength of the drawer and endorsers thereon. Such investments are not only as safe but also nearly as liquid as the interest bearing deposits held by correspondent banks and the rate of yield would be much larger than on such deposits.

It is earnestly urged that * * * savings institutions give careful consideration to the advantage of such investments for secondary reserve and as a means of temporarily absorbing surplus funds not available for long term investment.

Statement of Mr. George McLaughlin

Former Superintendent of Banks, State of New York

The Banking Law of the State of New York was amended in the year 1920 so as to make possible the investment of savings bank deposits in bankers acceptances. The maximum investment is 20% of the assets, less the amount held for reserve, which reserve averages about 5% of the assets.

The acceptances held by our savings banks constitute a secondary cash reserve. They are at the same time regarded as an excellent investment from both the standpoint of safety and revenue.

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